ANNUAL TRADE PROJECTION REPORT TO CONGRESS

Prepared Jointly by the Department of the Treasury
and the Office of the United States Trade Representative

March 1990

ANNUAL TRADE PROJECTION REPORT - 1990

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PART I: INTRODUCTION

The Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) contains numerous reporting requirements, including, in Section 1641, a requirement for an Annual Trade Projection Report. The impetus for this report reflected widespread concern about the emergence of substantial U.S. trade and current account imbalances and the impact of foreign economic trends and policies on these imbalances.

The report is to include a review and analysis of key economic developments in countries and groups of countries that are major trading partners of the United States, projections for developments in various macroeconomic variables in the reporting year and the following year, conclusions and recommendations for policy changes to improve the outlook, and the impact on U.S. trade of market barriers and other unfair practices.

The legislation specifies that the report is to be prepared jointly by the Treasury Department and the Office of the United States Trade Representative, in consultation with the Chairman of the Board of Governors of the Federal Reserve System. The Report is to be submitted on March 1 of each year to the Senate Finance Committee and the Ways and Means Committee of the House of Representatives.

Part II of this report reviews recent macroeconomic developments in countries or groups of countries that are major U.S. trading partners, as well as key recent developments in the U.S. economy. Part III presents projections for key macroeconomic developments in 1990 and 1991 in the same countries and country groups. The two main sections are organized as follows: Section 1 discusses economic growth, fiscal trends and current and trade account developments in the industrial countries; Section 2 reviews key developments elsewhere in the world economy, including the non-OPEC member Less Developed Countries, the Newly Industrializing Asian Economies, and the OPEC countries. Part IV reviews policy issues raised by these projections, and Part V discusses the impact on U.S. trade of market barriers and other unfair practices. Parts I - IV were prepared by the Treasury Department; Part V was prepared by the Office of the Trade Representative.

Readers are, in addition, referred to the Treasury Department's semi-annual Report to Congress on International Economic and Exchange Rate Policy, which discusses key issues, including exchange rate developments, in considerable depth and provides a more detailed review of important recent historical trends. That report was also completed under requirements in the Omnibus Trade and Competitiveness Act of 1988 (P.L.100-418).

PART II: REVIEW AND ANALYSIS OF DEVELOPMENTS IN 1989

I. Industrial Countries

Economic developments in the industrial countries in 1989 remained, as projected, broadly satisfactory. Aggregate real growth in the 24 OECD member countries slowed to a more moderate pace; consumer price inflation rates continued to pick up during the early part of the year but then generally subsided later on; additional reductions were achieved in some key external imbalances; and fiscal positions generally strengthened further.

A. U.S. Economic Performance

Although the available data for 1989 are still incomplete, they do indicate that U.S. economic developments tracked fairly well with official projections in key respects. Real GNP growth slowed, as forecast, from the better than expected 4.4 percent rate in 1988 to 2.9 percent in 1989 (both annual average rates). The consumer price inflation rate increased somewhat on average in 1989. On the external side, the U.S. trade and current account deficits were reduced further both in nominal terms and as a percentage of GNP.

In qualitative terms, U.S. GNP developments in 1989 were similar to those in 1988 and 1987. Real GNP grew more strongly than domestic demand (gross domestic purchases), with improving net exports making a positive growth contribution; private and public consumption growth rates were below that of GNP, while business investment growth was above; exports of goods and services was the single strongest GNP component, exceeding import growth by a significant margin; and, import growth slowed on an annual average basis.

Consumer price inflation averaged 4.8 percent in 1989, after a 4.1 percent increase in 1988. Excluding the more volatile food, shelter, and energy components, the CPI index was up 4.1 percent during the course of 1989 (i.e., December to December), versus a 4.7 percent increase in 1988. The broader fixed-weight GNP deflator rose only slightly, from 4.2 percent in 1988 to 4.5 percent in 1989, with measured price pressure clearly lower during the second half of last year.

Developments in the U.S. external accounts may be gauged by two different measures, the balance of payments and the national income and product accounts. Used together they can provide a comprehensive view of external developments, as well as insights into the important role that can be played by relative price developments. A discussion of the two measures merits a brief digression.

The national income and produce accounts (NIPA) presentation of foreign trade differs from the more traditionally used balance of payments presentation largely because of different treatment of a number international transactions. The most important difference is in the treatment of interest paid to foreigners on their holdings of U.S. government securities. These flows are included in the balance of payments reckoning (as part of the "balance on goods and services" and the "balance on current account") but, for a number of reasons, are excluded from the NIPA measure. In addition, the two measures give different treatment to capital gains and losses on direct investment income flows, gold transactions, and financial flows between the United States and its territories and Puerto Rico. Finally, the national accounts presentation is most familiar in its real, or price-adjusted, form (1982 dollars for the United States), while balance of payments aggregates are always shown as current nominal values.

A particular attribute of the NIPA measurement is that by separating the domestic side of the economy (essentially, public and private consumption and investment) from the external side (exports and imports of goods and services), it clearly identifies the relative contribution of each to the overall growth performance. In addition, current value NIPA aggregates may be adjusted with import and export price deflators to uncover underlying volume developments in goods and services flows. The resulting real aggregates are important in gauging the impact of U.S. external sector trends on production and employment. The balance of payments measure, on the other hand, provides the most comprehensive and internationally comparable picture of U.S. international transactions and is therefore more useful in analyzing U.S. developments in the context of financial market developments and the global economy.

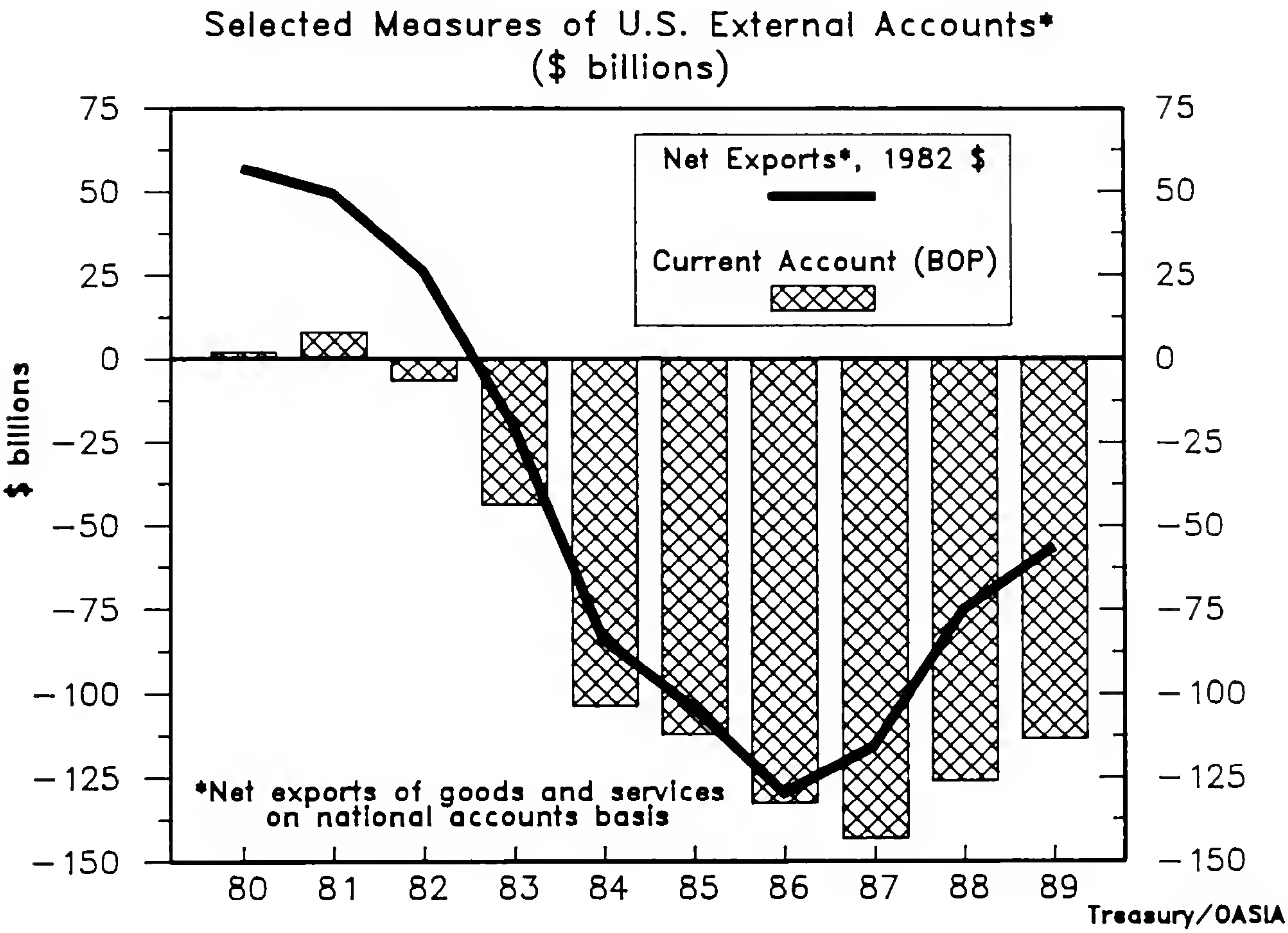
On the balance of payments basis, the U.S. trade and current account deficits were reduced further in 1989, and by greater amounts than many analysts had initially projected. Through the first three quarters of the year, the trade deficit (balance of payments basis, seasonally adjusted, annual rate) had been cut by almost $16 billion, to $112 billion. Over the same period the current account deficit was reduced by about $13 billion, to $114 billion. Both figures compare very favorably with the peak nominal deficits of $159.5 billion and $143.7 billion, respectively, registered in 1987. The trade deficit has been reduced from 3.5 percent of GNP in 1987 to 2.1 percent last year, and the current account deficit from 3.2 percent to 2.1 percent.

Deficit reduction was also evident on the national accounts basis. According to the advance GNP data now available, U.S. net imports of goods and services fell about $23 billion in nominal terms in 1989, bringing the total correction since 1987 to about $62 billion. In real terms (i.e., measured in 1982 dollars) net imports fell almost $19 billion in 1989, to a level $73 billion below the peak in 1986. Thus in both real and nominal terms U.S. net imports of goods and services in 1989 were less than half of recent peak levels. This external side correction has had a significant positive impact on the overall performance of the U.S. economy, adding an average of more than 0.5 percentage points per year to real GNP growth since 1986.

The key underlying factor in the external account improvement in 1989 was the continued relative strength of export growth, in both real and nominal terms. Over the first three quarters of 1989 the dollar value of total merchandise exports rose at an annual rate of 13 percent (balance of payments basis) while merchandise imports rose 6 percent. Preliminary national accounts data for 1989 as a whole show that goods and services exports rose an estimated 10.8 percent in real terms (i.e., corrected for price changes) while goods and services imports rose 6.4 percent. This continues the positive trend underway since 1986, during which time export volume growth has averaged about 14 percent annually versus import growth of about 7 percent.

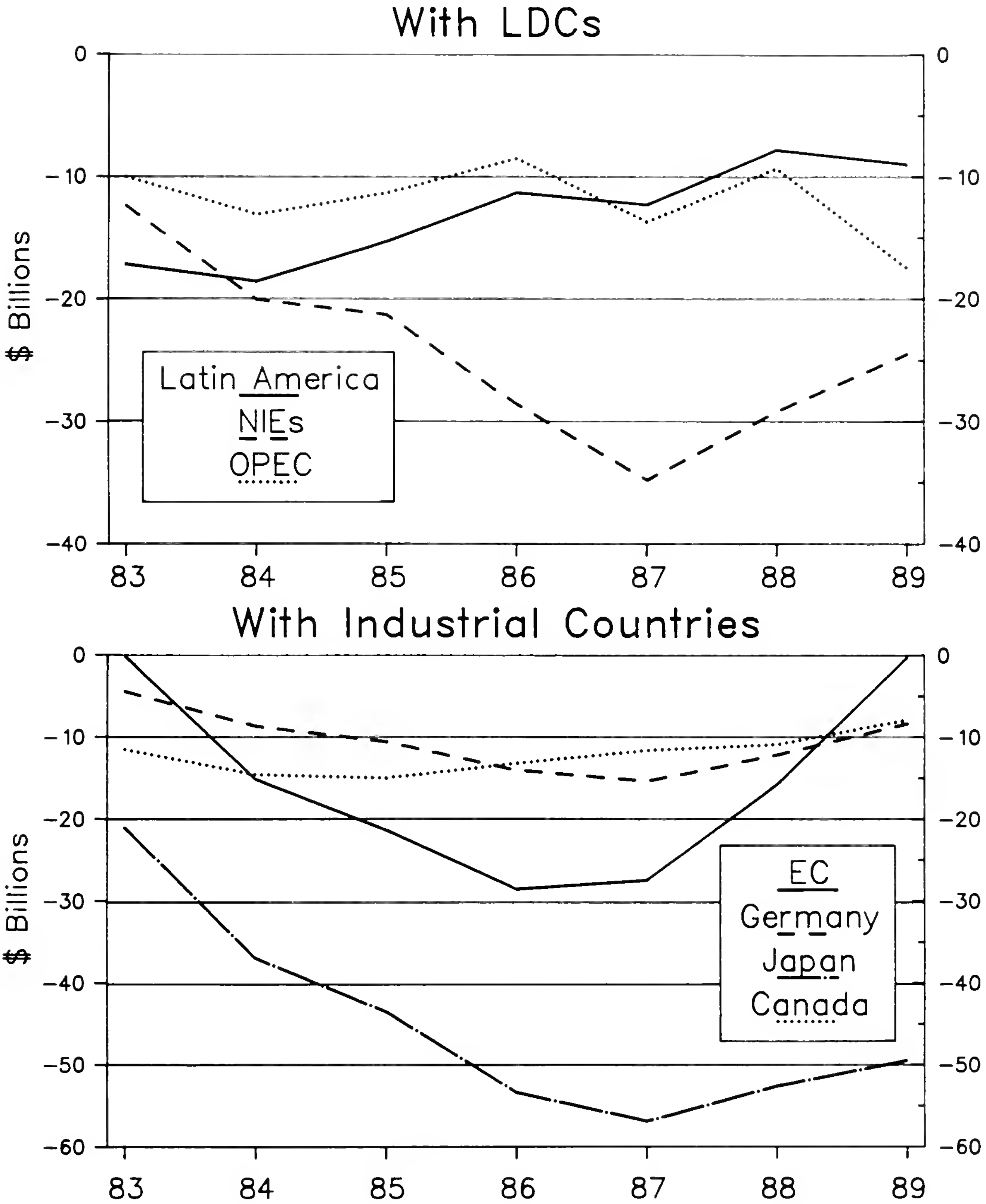
The chart on the following page presents U.S. external account trends according to the two measures in order to provide a useful comparison and to highlight the important role of relative price developments. By both measures, considerable progress has been made in reducing the U.S. external deficit from peak levels. However, the price-adjusted (1982 dollars) NIPA aggregate shows a substantially sharper correction since 1986.

The different behavior of value and volume is partially due to the fact that import prices have risen by more than export prices since 1986 (about 12 percent versus 6.5 percent); commodity price developments (particularly in the oil market) and exchange rate movements have been particularly important. Stripping out these price changes allows the effects of the rather different relative volume trends to be seen more clearly and highlights the substantial real adjustment that has actually occurred.



As was the case in 1988, the largest improvement in the U.S. trade deficit occurred vis a vis the industrial countries, which collectively absorb more than 60 percent of total U.S. exports. In 1989 the total U.S. merchandise trade deficit with the other industrial countries had dropped about $15 billion (census basis figures) relative to 1988. The correction was particularly pronounced with Western Europe, with the deficit dropping $11.3 billion. Of this amount, $10.6 billion was accounted for in trade with European Community member countries; indeed, the bilateral U.S. trade balance with the EC moved into surplus in 1989 for the first time since 1982.

U.S. Bilateral Trade Balances
($ billions; BOP basis)



The U.S. bilateral deficit with the Federal Republic of Germany fell $4.1 billion in 1989; since 1987, the U.S. deficit with Germany has been roughly halved (from about $15.5 billion), the largest bilateral improvement in dollar terms. The small U.S. surplus with the U.K. rose further in 1989 (contributing to a bilateral turnaround of about $5.5 billion since 1986), as did the long-standing U.S. surplus with the Benelux countries. In general, moderate reductions were recorded in the relatively small U.S. deficits with most other European countries. The U.S. bilateral deficit with Japan declined about another $2.8 billion last year.

The U.S. trade deficit with the non-OPEC member developing countries was reduced by about $3 billion last year. The relatively small deficits with Mexico and Brazil were reduced by a combined $1.8 billion. Once again, however, the largest shift in the non-OPEC LDC group occurred against the Newly Industrializing Economies of Asia whose combined surplus with the United States was reduced by about $3.9 billion. Within this group, U.S. deficits declined with Korea, Hong Kong and Singapore, but rose by about $0.4 billion with Taiwan. (This latter development largely reflects the statistical effect of special gold transactions in 1988 which temporarily reduced the recorded deficit for that year.)

The U.S. trade balance with the OPEC countries continued mainly to reflect changes in oil prices and import volumes. With average oil import prices rising appreciably in 1989 (about $3.50 per barrel), and import volume rising as well, the OPEC surplus with the United States increased by about $8 billion (i.e., nearly doubling, to $17.4 billion). This negative trade balance shift with OPEC is an extremely important component of the overall U.S. trade balance picture. In fact, the shift in the bilateral balance with OPEC offset more than half of the total U.S. trade deficit reduction with the rest of the world in 1989 and was therefore a major factor in the slower overall pace of nominal trade adjustment last year.

On a commodity basis, there were a number of noteworthy developments in 1989. Exports and imports of capital goods (excluding the automotive sector) both rose by about 14 percent (census basis, nominal terms). In the automotive sector, trade flows remained essentially unchanged, with exports rising slightly and imports declining slightly. However, in the consumer goods (excluding autos), food, and "other merchandise" (which includes military goods) categories -- together accounting for about one-third of total U.S. exports -- exports increased by a combined 13 percent versus an import increase of about 5.7 percent. In fact, "industrial supplies and materials" was the only commodity category where import growth (12 percent) exceeded export growth (9 percent).

B. Developments in Other Industrial Countries

The real rate of GNP growth in the foreign industrialized countries (the OECD excluding the United States) decelerated by about one-half of a percentage point in 1989, to an estimated 3.7 percent. The slowdown to a more moderate growth rate was fully anticipated in light of a number of factors. First, the investment surge of 1988 was seen as unlikely to persist with the same strength in 1989 given generally tighter monetary conditions and the capacity augmentation already achieved. Second, private consumption growth was also projected to ease, reflecting policy measures in key countries as well as lower real disposable income gains. Finally, public consumption growth rates continued to be squeezed by the ongoing general emphasis on fiscal consolidation.

The combined impact of slower growth rates in each of its major components reduced aggregate domestic demand growth outside the United States by about a full percentage point, to an estimated 4.3 percent, in 1989. Nevertheless, domestic demand growth in the entire group of foreign industrialized countries continued to exceed overall GNP growth last year. This was also the case for the six foreign Summit economies, whose aggregate GNP and domestic demand growth rates were also 3.7 and 4.3 percent, respectively. In the international framework this means that, in aggregate, real net imports of these countries increased and macroeconomic trends remained supportive of continued external adjustment.

Inevitably, there were important differences in the performances of individual countries. In Japan, real GNP and domestic demand growth were again the highest in the Summit country group, though both eased relative to 1988 (GNP: 4.9 percent vs. 5.7 percent; domestic demand: 6.0 percent vs. 7.6 percent). Thus, the gap between GNP and domestic demand growth in Japan narrowed from nearly two percentage points in 1988 to about one percentage point last year. Private consumption growth slowed fairly substantially due to the impact of tax changes and higher inflation on real disposable income, as well as an increase in the household saving rate. Investment spending, however, remained quite strong as higher business equipment investment largely offset slower housing and public investment increases. On the external side, import growth remained at the very strong level of 1988 (21 percent in real terms, NIPA basis); however, the contractionary effect of this on net exports was partially offset by a strengthening of export growth to about 14.5 percent.

Overall developments in the European Summit countries were qualitatively similar to those in Japan. Consumption and investment growth rates slowed, lowering both domestic demand and GNP growth; and the GNP/domestic demand growth gap narrowed by about one percentage point. However, developments in the four countries were not as uniform as they were in 1988, and there were some fairly significant divergences.

Germany was the only Summit country experiencing higher GNP growth in 1989 (4.0 percent after 3.6 percent in 1988). However, domestic demand growth slowed markedly, to an estimated 2.4 percent, a rate well below that of GNP growth. The domestic demand slowdown was due entirely to much reduced consumption growth. Investment spending, in contrast, actually strengthened further, making Germany the only Summit country where this was the case. The key reason for the consumption slowdown was higher inflation and excise taxes which eroded consumers' real disposable income, overwhelming purchasing power gains arising from higher wage increases and job creation as well as a slightly lower household saving rate. In addition, public consumption contracted slightly in real terms in 1989. As was the case in Japan, German import growth (NIPA basis) remained at about its 1988 level (6.5 percent) while export growth accelerated (from about 6 to 11 percent). Thus, net exports rose, and contributed substantially to overall GNP growth.

In the U.K. the situation was quite different. GNP growth fell by half, to the lowest rate (2.0 percent in the Summit country group. Domestic demand growth also declined sharply (to 3.5 percent), as both consumption and investment growth were reduced from the unsustainably very high rates posted in 1988. Although export growth revived solidly, it continued to trail the somewhat slower import growth rate by a wide margin. As a result, the U.K.'s external deficit widened further in 1989, and developments on the external side continued to have a major dampening effect on overall economic growth.

Economic developments in Canada in 1989 were somewhat similar to those in the U.K. While domestic demand growth slowed, it continued substantially to exceed GNP growth, with the difference covered by rising net imports and a deteriorating external balance. In Canada, however, goods and services exports may actually have contracted slightly in real terms in 1989, reflecting exchange rate developments and reduced demand growth in crucial U.S. markets.

The investment and consumption upswing was also shared by the smaller OECD economies, though it appears to have gotten a somewhat later start than in the largest economies. In fact, aggregate GNP and domestic demand growth strengthened in these countries in 1989 (versus the cooling in the Summit

economies). Domestic demand again grew more strongly than GNP (in part reflecting rapid domestic demand growth in some of the larger economies in this group such as Spain and Australia), contributing to a sharp increase in the group's aggregate external deficit.

C. Macroeconomic Policy Developments

Macroeconomic policies in 1989 remained generally oriented toward the medium-term objectives of sustained low-inflation growth and consolidation of the public finances. On the monetary side, concern about actual and potential inflationary pressures has coexisted with uncertainty about the underlying strength of the economic expansion, and policies have followed a cautious and moderately restrictive path. Budget positions have strengthened, reflecting both the revenue bonus of favorable macroeconomic trends and an underlying emphasis on medium-term expenditure restraint. This overall restrained policy mix appears to have succeeded in dampening inflation expectations during the course of 1989 while at the same time accommodating growth.

The further strengthening of industrial country budget positions last year continues a general trend that has been underway for the past several years, though clearly important differences exist among the individual countries. Recent improvements, with the consolidated budgets of major countries moving strongly into surplus or toward balance, reflect a number of factors. The stronger economic growth in recent years has acted as an automatic stabilizer, raising income and tax revenue and limiting the growth of social outlays such as transfers to the unemployed. In a number of countries these revenues have been used to cushion the budgetary impact of tax reform. In addition, public expenditures are being subject to greater scrutiny, and progress has been made in reducing expenditure growth rates. Overall, however, it appears that the bulk of the budget consolidation gains derive from cyclical factors rather than tax or expenditure policy changes.

The Japanese central government budget surplus (including social security) rose further to 2 percent of GNP in 1989, a marked strengthening since the small deficit registered in 1986. The general government budget (including the equivalent of state and local budgets) also moved into greater surplus in 1989 (to 1.7 percent of GNP). The longstanding fiscal policy goal of eliminating the issuance of deficit financing bonds has essentialy been achieved in the context of strong, growth-related revenue growth and a conservative spending approach.

The German budget position is also stronger than it was several years ago despite a multi-year tax reform/reduction program. In 1989, the central government deficit was cut to an estimated 0.7 percent of GNP and the general government deficit to 0.3 percent. The improvement was mainly a revenue side phenomenon, reflecting selected excise tax increases implemented on January 1 as well as last year's stronger growth performance.

In the U.K., revenues have been boosted by growth and higher inflation (tax reforms notwithstanding) while public spending has been restrained. The central government budget surplus (achieved in 1988) increased further to 1.5 percent of GDP in 1989, and the general government surplus rose to 1.6 percent.

Canada has made significant progress under its medium-term program of fiscal restraint implemented to reduce a general government deficit that amounted to 7 percent of GNP in 1985. However, some of this progress was reversed in 1989 as revenue growth slowed and debt service payments rose. France has divided its growth/revenue dividend among tax cuts, additional spending and debt reduction within the context of a steady, but gradual, squeeze on the deficit. Elsewhere in the industrial country group there has been a general commitment to budgetary improvement and, on the whole, progress in fiscal consolidation has been made in recent years.

D. Trade and Current Account Developments

In aggregate, further progress was made in 1989 in reducing key trade and current account imbalances outside the United States, with the combined surplus of the other OECD countries again declining substantially. Nevertheless, there were some important differences in developments in individual countries.

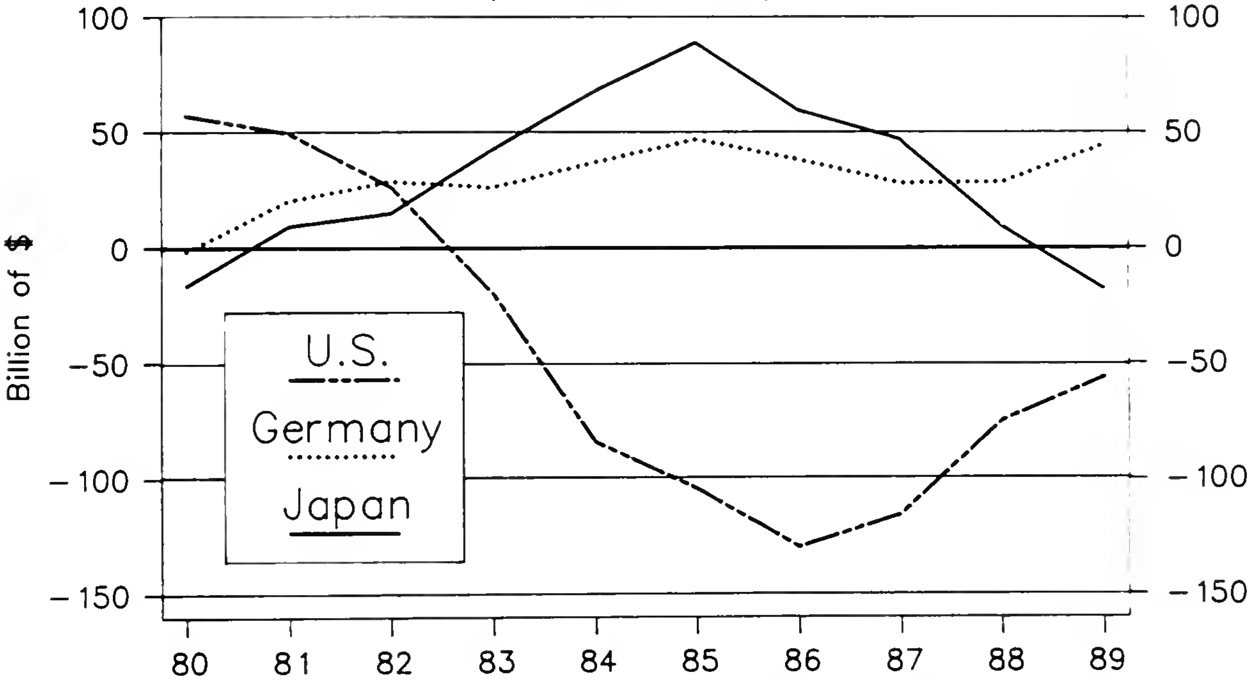
Japan's current account surplus was reduced by nearly $23 billion further in 1989, to an estimated $57.0 billion, a correction that exceeded the expectations of most forecasters. The bulk of this reduction was registered on the trade account, though the Japanese deficit on services and transfers continued to expand as well. Since its 1987 peak, the current account surplus has been reduced by $30.0 billion, or from 3.6 percent of GNP to 2.0 percent. The trade surplus reduction in the past two years has totaled just over $19 billion while the invisibles deficit has risen about $11 billion.

Several factors have contributed to external adjustment in Japan. Import volume growth (census basis) has exceeded export volume growth since 1986 largely reflecting the relative increase in domestic demand in recent years. In

1989, import growth slowed to about 8 percent (after an exceptional 16.5 percent surge in 1988) while export growth remained at about 5 percent. As for the invisibles account, the rising deficit mainly reflects sharply higher Japanese tourism expenditures.

As has been the case in the United States, the nominal balance of payments figures for Japan do not fully capture the underlying degree of adjustment, particularly when the current account is expressed in dollar terms. In yen terms, Japan's current account surplus declined 46 percent between 1986 and 1989, versus 34 percent in dollar terms; on the trade account the decline was 32 percent in yen terms versus 17 percent in dollar terms. These large differences reflect exchange rate developments; during a period of dollar depreciation, an unchanged yen surplus will be higher when expressed in dollar terms, the lower the exchange value of the dollar.

Net Foreign Balances*
(Billions of $)



*Net Exports of Goods and Services on National Accounts Basis, Germany & Japan 1980 $, U.S. 1982 $

Japanese external adjustment has also been much more substantial in real terms than in nominal terms. On a price-adjusted national accounts basis, Japanese net exports of goods and services have declined sharply since peaking in 1985. The difference between the real and nominal aggregates, as with the real external position of the United States, relates mainly to sharply different price and volume trends.

Since 1985, Japanese imports have risen a total of about 63 percent in real terms while exports have risen 22 percent. These trends are isolated by the price-adjusted NIPA figures for net exports presented above. On the balance of payments basis, however, the impact of the strong import volume rise is substantially offset by the major import price decline (about 40 percent) over the same period.

In Germany, external accounts have developed differently. Both the trade and current account surpluses increased in 1989, to an estimated $75.5 and $55.8 billion, respectively. Both are new record levels in both nominal terms and as a percentage of GNP. Despite the relative weakness of domestic demand growth last year, import volume growth strengthened to nearly 7 percent, its highest rate since the external adjustment process got underway in 1985. However, export growth increased even more strongly (rising to 9.8 percent), largely reflecting robust demand for German-made investment goods in other European countries. In addition, Germany's deficit on services declined markedly in 1989, the result of much higher investment income receipts on its growing net foreign asset position. On a regional basis, Germany's trade surplus has declined with the United States and risen very steeply with other European Community member countries; thus, external trends elsewhere in Europe to some extent mirror those in Germany.

On the national accounts basis, Germany's goods and services surplus was reduced by about 40 percent in real terms between 1985 and 1988; over that period, import volume rose 23 percent while export volume rose 18 percent. However, much of this correction was reversed last year (see chart on previous page) as export growth rebounded strongly in real terms while import growth remained steady.

The U.K. has experienced a rapid deterioration in its external position over the past few years, highlighted by a very sharp deficit increase in 1988. The current account deficit rose further in 1989, though more slowly, to an estimated $35 billion. Manufactured imports have soared over the past few years due in part to the strong revival of investment activity in the U.K. On the other hand, exports of manufactured goods have begun to pick up, though the effect on the overall trade balance has been obscured by adverse oil market developments.

Italy's current account deficit roughly doubled in dollar terms in 1989, though it remains relatively low in nominal terms ($10.5 billion) and in proportion to GNP (1.2 percent); on the trade account, Italy remains very near balance. Canada's trade account remained in modest surplus ($5 billion) in 1989, despite further moderate erosion. The current account deficit, however, increased markedly (to $15 billion) due to much higher service payments abroad. France's current account deficit rose only slightly in 1989 and remains low in dollar terms ($4 billion) and in proportion to GNP (0.4 percent).

A number of external account developments in the smaller industrial countries merit brief mention. With the rebound in oil prices, and slow domestic growth, Norway's current account shifted favorably by about $5.5 billion. In Spain, the current account deficit (which appeared only in 1988) widened appreciably as very strong investment and consumption growth continued to absorb imports.

2. Economic Trends Outside the Industrial Countries

The non-OPEC member developing economies continued to expand in 1989, albeit at a slower aggregate rate than in recent years. Inflation developments within the group remained highly divergent. Given higher inflation in some of the largest economies, the GNP-weighted average consumer inflation rate for the entire group increased substantially; however, average rates actually declined in most countries. Debt indicators improved marginally despite higher interest rates. Finally, the combined current account deficit of the group increased by about $20 billion.

Weighted average GNP growth in the non-OPEC LDCs in 1989 is estimated at about 3 percent, after 3.9 percent in 1988. Slower growth in the Newly Industrializing Economies of Asia (NIEs)) was a major contributing factor; average growth increased marginally in the major debtor countries as well as in the large group of smaller economies. Specifically, aggregate growth in the NIEs (Korea, Taiwan, Hong Kong and Singapore) slowed from 9.9 percent to 6.6 percent, with Korean real growth dropping into single digits for the first time in several years.

Real growth rebounded moderately in Brazil, Mexico and Chile (to about 3, 3, and 9 percent, respectively), but contracted significantly in Argentina (-5 percent) and Peru (-15 percent). For Peru, 1989 was the second consecutive year of major economic contraction in real terms. Qualitatively, the regional LDC growth picture was not significantly changed in 1989. The NIEs group remained the clear growth leader, while Latin America remained the low growth region.

Inflation accelerated dramatically in a few major LDCs in 1989, boosting the weighted average rate for the 137 member non-OPEC group from about 200 percent in 1988 to just over 500 percent. In Argentina, the rate rose from about 350 percent to over 3000 percent; in Brazil, the increase was from about 680 percent to nearly 1500 percent; and in Peru, the rate jumped from about 900 percent to about 5400 percent.

However, while these developments strongly affected the averages in 1989, they were not representative of inflation trends elsewhere in the developing world. In Mexico, for example, inflation was cut from nearly 115 percent in 1988 to an estimated 22 percent last year. In fact, excluding Argentina, Brazil and Peru from a fairly representative group of 24 (mostly major) non-OPEC LDCs shows that inflation in most declined substantially in 1989 rather than rose. (These 24, in alphabetical order, are: Argentina, Bangladesh, Brazil, Chile, Colombia, Egypt, Guatemala, India, Israel, Ivory Coast, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Singapore, Syria, Taiwan, Thailand, Tunisia, and Zaire. Average inflation in the 24 was 212 percent in 1988 and 595 percent in 1989; inflation in the group excluding Argentina, Brazil and Peru was 35 percent in 1988, but only 13 percent in 1989.)

The combined current account position of the non-OPEC LDCs moved from rough balance in 1988 to a deficit estimated at $21 billion in 1989. The shift almost exclusively represents external developments in two groups: the NIEs, and the largest debtor nations.

The combined current account surplus of the four Asian NIEs declined again in 1989, falling to $19 billion versus its 1987 peak of $30 billion. Korea's surplus was more than halved, to about $6 billion; Taiwan's surplus is estimated to have declined only slightly last year (to $10 billion), though it was still down about $8 billion from its 1987 peak.

The current account deterioration in a selected group of nine major LDC debtors was largely accounted for by developments in three countries. (The 9 countries are: Argentina, Brazil, Chile, Colombia, Ivory Coast, Mexico, Morocco, Peru and the Philippines.) Brazil's small surplus essentially disappeared in 1989, while Mexico's current account deficit rose by about $2.5 billion. (A partial counterpart of these shifts may be found in the diminished U.S. bilateral deficits with each country in 1989.) In addition, the deficit of the Philippines about doubled to $2.3 billion. In the other countries in the group there was little significant change in 1989.

The external position of the OPEC member countries improved substantially in 1989 as oil prices and export volumes both increased considerably. Average prices fluctuated a good bit during the year, opening at $15.75 per barrel, climbing to a three year high of $19.00 per barrel in April and finishing at about $18.50 per barrel. Incomplete data suggest that 1988's estimated $16 billion deficit for this group was eliminated last year, and a surplus of about $5-1/2 billion was achieved. In addition to higher export earnings, restraint on import increases contributed to the change.

PART III: PROJECTED DEVELOPMENTS IN 1990 AND 1991

The global economic expansion is now into its eighth consecutive year, and is expected to continue -- at a somewhat lower overall rate -- through 1991. World trade growth should on average cool somewhat as well, though still expand at more than double the aggregate rate of GNP growth; thus global trade will remain, as has been the case during the entire postwar period, an important contributor and stimulus to economic growth. Inflation should follow a moderate path, with greater international convergence toward a lower aggregate rate. Overall progress in reducing external imbalances is likely to slow in nominal terms; however, imbalances at the end of 1991 are projected to be lower in proportion to GNP than at the end of 1989. The macroeconomic policy blueprint of the past few years -- monetary caution and fiscal restraint -- will continue to be the basic guide, though there are real uncertainties for some countries and there will inevitably be significant differences among individual countries.

1. Prospects for the U.S. Economy

U.S. economic growth is projected to be somewhat slower, on average, in 1990/91 than in the 1988/89 period. Specifically, real GNP growth this year is forecast at 2.4 percent (year-over-year), with greater strength in the latter part of the year leading into an average growth rate of 3.2 percent in 1991. The rate of growth of domestic demand is expected to remain somewhat below that of GNP (as it has since 1987).

Thus, further moderate reduction of net imports should be achieved in real terms as the growth of goods and services exports continues to exceed that of imports. But achieving additional reductions in the U.S. current account deficit will be a function of a wide array of factors such as (but not limited to): foreign growth and its composition; the impact of exchange rate movements in 1989; future interest and exchange rate developments; and, international price trends. In the light of the projections for 1990 and 1991, the U.S. trade and current account deficits could improve further in 1990/91, though improvement is not likely to be as significant as in the 1988/89 period. Moreover, given the usual forecasting uncertainties, the prospect of nominal deficit increases cannot be ruled out. This being said, however, there are good prospects for further declines in both deficit measures as a percentage of GNP. (Additional detail on the Administration's medium-term forecast is contained in the FY1991 budget.)

One supplemental point about the U.S. external adjustment process is worth making. During the past two years actual reductions in the U.S. deficits have generally exceeded those predicted by conventional balance of payments computer models. Analysts have suggested that these forecasting errors may in part reflect the failure of conventional balance of payments forecasting models adequately to capture the trade effects of the structural economic changes that have occurred in the past decade.

These would include, among other things, the trade-diverting effects of large direct foreign investment flows as well as shifts in trade flows arising from substantial and non-temporary changes in international supply conditions. For example: as a result of U.S. wage moderation and the dollar depreciation of recent years, there has been a substantial absolute (as well as relative) improvement in the cost competitiveness of U.S. suppliers. Conventional models, built as they are upon historical relationships, may not be fully incorporating this development. Thus, it may be that continuing structural changes in the U.S. economy could produce more external adjustment than now predicted econometrically. In any event, these considerations suggest that the standard projections need to be handled with some care.

2. Projections for Other Industrial Countries

A. Overview

The economic expansion is expected, likewise, to continue in the other industrial countries in 1990, but at a more moderate aggregate rate as investment activity slows somewhat. Inflation also is projected to slow, reflecting a better capacity/demand match as well as the absence of some of the one-time price boosting influences at play in 1989. Additional external imbalance corrections are expected this year, though the overall pace of adjustment is likely to slow in both nominal and real terms. Thus, in key respects 1990 is projected to show, qualitatively, a broad continuation of the trends which emerged during the latter part of last year.

These projections reflect in part the view that 1990 may prove to be an important transition or, perhaps better stated, consolidation, year for the industrial economies. First, the substantial (and unexpectedly robust) output and employment gains of recent years followed a period of already solid growth. Thus, for some countries this year may mark something of a "breathing" period, while for others (the U.K. and Canada, in particular), it may be a year in which the effects of policy corrections are particularly pronounced.

Second, the resiliency of the expansion, and sensitivity to the potential for inflation pressures, has led to a generally more restrictive policy stance. In addition, there may be a greater readiness on the part of the monetary authorities to act early when price pressures are considered worrisome or, at minimum, a heightened perception on the part of economic agents that this is the case.

Third, absorption of the recent investment surge is still underway, with its impact on expectations, productivity, and potential output rates still filtering through. The same could be said of the structural improvements implemented in recent years (tax reform, deregulation, privatization) which will have national and cross-border dimensions that will only become evident over time.

Finally, the dramatic developments in Eastern Europe could have potentially important effects on trade and investment patterns both within and outside of Europe. Increased East European consumption and investment will have both trade-creating and trade-diverting effects and could, over time, contribute to stronger world trade growth and reduction of the existing trade imbalances. While perceptible evidence of these developments is likely to be limited in 1990, the sentiments and expectations of businesses and policy officials have clearly already been affected.

The advance outlook for 1991 to some extent reflects adjustment to these underlying factors. Overall industrial country growth is expected to strengthen marginally relative to this year's 3 percent level. Average inflation in the foreign OECD countries should moderate slightly further in 1991, to around 4 percent. Robust world trade growth will continue to provide solid stimulus to both global output expansion and the external adjustment process.

<u>B. Economic Growth</u>

Aggregate GNP growth in the foreign industrial countries is projected to be marginally slower this year (3.3 percent after 3.7 percent in 1989). To some extent this should reflect, as noted above, a generalized cyclical slowdown in investment activity. GNP growth rates in the individual economies are expected to be more divergent this year than last as a result mainly of differing policy developments. Aggregate domestic demand growth also is expected to slow to around 3.3 percent in 1990, with lower average growth rates in the smaller Summit countries as well as the non-Summit OECD group. However, domestic demand growth in the two largest surplus countries, Japan and Germany, should exceed the average OECD and U.S. rates.

Japan is expected once again to post the highest GNP growth rate in the Summit country group, and indeed the average rate could accelerate somewhat this year. Rebounding private consumption should be an important contributor as growth picks up with the passing of some of the uncertainty and volatility caused by last year's introduction of a new consumption tax. Investment activity, on the other hand, is likely to slow (but still remain solid) after two years of double-digit real growth. The combined impact of these developments, coupled with continued tight restraint on public sector expenditures, should squeeze domestic demand growth slightly. Nevertheless, domestic demand growth in Japan in 1990 is expected to remain appreciably above both Japanese GNP growth and domestic demand growth in the other major industrial economies.

The projected picture for Germany in 1990 differs in key respects. Average GNP growth is forecast to slow moderately from last year's unexpectedly strong 4 percent rate; however, domestic demand growth is likely to strengthen appreciably from its modest advance in 1989. Stronger private consumption growth should provide important stimulus this year, after acting as a drag on growth in 1989. Central to the shift will be the implementation of the third and final stage of Germany's multi-year tax reform, which will provide relief to taxpayers across the income scale; in 1989, in contrast, private consumption growth was inhibited by increases in selected excise taxes and social fees. In addition, private consumption expenditures are likely to be boosted by the significant inflow of low-saving immigrants from Eastern Europe. As is projected for other industrial countries, investment growth should cool somewhat, though probably to a rate that will still exceed overall GNP and domestic demand growth. Thus, with strengthening domestic demand replacing net exports as the principal source of growth, basic macroeconomic trends in Germany should be more supportive of external adjustment in 1990 than was the case in 1989.

For the U.K. and Canada, 1990 is likely to be an important consolidation year. In both countries, vigorous domestic demand growth in recent years led to deteriorating external positions as well as concerns about inflation. In particular, further consumer spending retrenchment is in prospect for both countries this year in lagged response to policy adjustments over the past year and a moderate restocking of household saving. Public consumption growth is being scaled back in Canada and has been held near zero in real terms in the U.K. for several years. Finally, investment growth in both countries is expected to continue to ease from the double digit rates recorded in 1988. For both, domestic demand growth projected below GNP growth represents macroeconomic impetus for some moderate external adjustment.

In France, GNP growth is forecast to decline very slightly in 1990 from the 3.4 percent average rate of the two previous years. The slowdown, mainly reflecting a minor easing of both private consumption and investment growth, should be most evident in slightly slower domestic demand growth, which is expected, nevertheless, to remain near 3 percent. A similar profile is projected for Italy, where domestic demand growth is forecast to drop below 4 percent for the first time in several years. Here, too, private consumption and investment growth rates are likely to ease somewhat. In both France and Italy, domestic demand growth should exceed GNP growth by a small margin.

After hitting a decade-high peak of about 3.8 percent in 1989, aggregate GNP growth in the smaller OECD countries is expected to slow to around 3 percent this year. Domestic demand growth in some of the larger members of the group (Spain, the Netherlands, Australia, Sweden) is expected to slow, in part in response to concerns about inflation and external developments. For many of the smaller countries, investment growth is likely to tail off somewhat this year after strong growth in 1989; to a lesser degree, so should private consumption growth.

Growth projections for 1991 are necessarily still rough, though there is a firm consensus that the expansion should continue at a moderate and sustainable pace. Within the Summit country group, aggregate GNP growth should be equal to or slightly in excess of growth this year, putting it in the range of 3 to 3-1/2 percent in real terms. U.S. growth is projected to recover moderately after this year's slowdown, as could growth in the U.K. and Canada. For the U.K., this reflects the view that private consumption and investment will recover marginally from this year's consilidation. In the case of Canada, the growth rebound is likely to be less strong than in the U.K. (albeit at a higher overall level) owing largely to implementation of the new value-added tax.

Private consumption, investment and exports should continue to provide support for the German economy, with East European emigration and economic reforms providing an additional growth impetus. Estimates of the incremental growth effect of these developments vary substantially, though most analysts see a growth bonus of at least 0.5 percentage points; thus, German GNP growth in 1991 could again be in roughly the 3-1/2 to 4 percent range. The Japanese economy should continue to show better than average strength, the product mainly of steady consumption growth; investment should remain healthy but, in light of the sharp increases in recent years, appreciably slower annual growth is forecast. Finally, the growth process in both France and Italy appears quite stable at this point, and both could well turn in GNP growth in roughly the same range as this year.

Aggregate GNP growth in the smaller OECD economies is forecast to remain in the 2-1/2 to 3-1/2 percent range in 1991. Spain and Portugal, the newest EC member countries, are likely to remain among the top growth performers in the group. The Scandinavian countries, on the other hand, are widely expected still to be in an adjustment phase (for different reasons) and should remain among the lower growth countries. Domestic demand growth in the smaller country group is likely slightly to exceed GNP growth. The Spanish and Portuguese economies should, in particular, remain domestic demand driven.

C. External Account Developments

The external adjustment process in the foreign industrial countries is expected to continue, in aggregate, over the 1990/91 period, though with some significant differences among developments in individual countries. The continuation of real economic growth at a solid pace through 1991 will be both a product of and a stimulus to continued strong world trade growth. In real (i.e., volume) terms OECD trade is expected to expand an average of 6-1/2 to 7 percent in 1990/91, or more than twice as fast as overall GNP growth. (This 2:1 ratio of trade to GNP growth has been a remarkably constant medium-term feature of the postwar period, and is eloquent testimony to the role of free trade in stimulating global growth, development and prosperity.)

The combined current account surplus of the foreign Summit countries declined dramatically in 1989 (from $85 billion to $50 billion), largely reflecting the major current account correction in Japan. However, further such huge declines seem unlikely in 1990 and 1991. In Japan, rising investment income earnings and a partial recovery of export growth will probably limit the potential for further nominal declines in the surplus this year and next, and modest increases cannot be excluded. As a percentage of GNP, however, the Japanese current account surplus should remain in the 2 percent range, down sharply from its 4.3 percent peak in 1986. With German domestic demand growth somewhat stronger than elsewhere in Europe, on average, its import growth should remain solid, and get an additional boost from the incremental domestic demand associated with the population influx from Eastern Europe. On the other hand, however, German exports to West European markets remain strong, and foreign investment earnings are growing rapidly. On balance, therefore, Germany's external surpluses may continue to rise, in nominal terms and as a percentage of GNP. A key factor driving future current account developments in both Japan and Germany is the existing excess of exports over imports; in the current circumstances even import growth that is appreciably higher than export growth could be consistent with steady surpluses.

Relatively small movements are anticipated in the remaining foreign Summit countries. Slower domestic demand growth in the U.K. should compress imports and contribute to moderate reductions in the trade and current account deficits through 1991; much the same picture should apply to Canada as well.

In France, the current account deficit is projected to remain relatively small as import growth cools somewhat while exports continue to benefit from improving French cost competitiveness. In Italy, external sector trends are more of a concern due to competitiveness problems, but increases in external account deficits through 1991 should be modest.

With the exception of Spain, external imbalances in the smaller OECD countries are relatively small in dollar terms. The aggregate small country current account deficit, however, could increase to the $30 billion range by 1991 due primarily to anticipated continued increases in the Spanish deficit.

D. Fiscal Policy

Fiscal policy in the major countries will continue to be formulated within the broad framework of medium-term budget consolidation. Discretionary policies generally geared toward expenditure restraint, coupled with continued growth-driven revenue gains, should keep the OECD economies on the path of declining aggregate deficits through 1991. In numerous countries, emerging demographic trends are putting budget planning into an increasingly long-range framework: near-term budgetary strengthening is seen as essential to deal effectively with future strains arising from aging populations and a declining ratio of workers to retirees.

In Germany, the average budget deficit will be higher in 1990 and 1991 than in 1989 due to tax relief this year as well as substantial unanticipated expenditures associated with the East European emigrants. It is far too early to assess the potential budgetary implications of the German unification process. However, it is reasonable to expect that in the short to medium-term the process would result in higher expenditure growth than would otherwise have been the case, with revenue gains emerging less rapidly. On present course, fiscal policy in Japan will remain slightly restrictive through 1991, with continued solid revenue growth financing higher expenditure growth for both public consumption and public investment. When the social security system is included, the Japanese central government has had a growing surplus since 1987.

The U.K. will remain on the restrictive expenditure course it has followed for several years, though the growth slowdown will have adverse effects on revenue gains. The

French budget, in contrast, should continue to benefit from macroeconomic developments, with revenue gains only partially used for spending increases; as a result, the deficit should decline further in relation to GNP. The Italian budget deficit is likely to remain high relative to GNP, although discretionary actions should have a net favorable effect on the public finances. In Canada, reduction of the fiscal deficit is expected due to expenditure restraint and discretionary tax increases.

E. Developments in Eastern Europe

The unfolding events in Eastern Europe add a new and potentially significant element of forecasting uncertainty to what is already an intrinsically uncertain exercise. Clearly, reform in Eastern Europe will directly affect economic developments in the industrialized countries, particularly Western Europe and, most immediately, the Federal Republic of Germany. However, until the scope and pace of these reforms is better understood, any assessment of their macroeconomic effects on the industrial country external adjustment process must be fairly rough. Nevertheless, it may be useful to review, in broad terms, what they might be.

If East European reforms are substantial, and if they move firmly in the direction of market-oriented, democratic societies, the reforms should have a favorable medium-term effect on the industrial country external adjustment process. This should occur through two different channels. First, consumption and investment growth in the region is likely to be higher, the latter the product of the necessary industrial modernization as well as the improvement of the social infrastructure. Of course, the magnitude of the increases will be constrained in part by the availability of financing, which is itself a function of the seriousness of reform efforts in the individual countries. Higher expenditures in Eastern Europe will need to be covered by higher imports, much of them from the OECD countries. Thus, evolving markets in East Europe should produce higher demand for direct exports from the OECD area.

Second, there are likely to be favorable indirect effects arising in large part from the unique circumstances of the Federal Republic of Germany (FRG). The substantial influx of immigrants into the FRG will produce a discrete increase in domestic demand in an economy in which capacity utilization is already quite high. The implication will be increased absorption of imports by the FRG as well as increased domestic absorption of goods that might otherwise have been exported. In the first instance, this creates direct opportunities for foreign suppliers; the second case implies more opportunities for non-German suppliers in third country markets.

In addition, FRG producers are well-placed to supply a significant share of the incremental investment/infrastructure needs of East Germany. This, too, will tend to divert to East Germany a portion of FRG capital goods exports that would otherwise have gone to other industrial countries, creating incentives for domestic production increases in these countries as well as for imports from third countries. There will, of course, also be enhanced supply capability from the immigration to the FRG.

Thus, slowly at first, but increasingly over time, market reforms in Eastern Europe could contribute to reductions in the external surpluses of the FRG and the large intra-EC trade imbalances that now exist. Both must be important components of the overall international adjustment process.

3. Projections for the Non-Industrial Countries

The developing countries are expected to achieve higher aggregate real growth in 1990-91, rebounding from the slowdown last year. Most of the improvement will be located in Latin America and the Middle East/North Africa regions, although growth in Latin America will still be low. In Latin America, improved Mexican economic policies are expected to lead to increased growth in both 1990 and 1991, and Argentina is expected to halt the decline in GDP, which amounted to roughly 5 percent last year. Brazil's growth will probably remain sluggish this year, down slightly from 1989, but followed by higher growth in 1991. Thus for the region as a whole, we anticipate aggregate growth will rise to the 2-1/2 to 3 percent range through 1991.

Last year, severe inflation problems were confined to several countries in Latin America, particularly Argentina, Brazil, Peru and Nicaragua. While some improvement is projected for 1990-91 in Argentina and Brazil, inflation in these four countries is expected to remain at three and four digit rates. Aggregate inflation in the remaining LDCs is expected to fall to the 10-20 percent range in 1990-91, from the 30-40 percent range in 1986-88.

Growth prospects for the Asian NIEs remain quite good. While slower than the double digit levels of the mid-1980s, the aggregate growth rate is expected to remain near last year's 6 1/2 percent level through 1991. For the two biggest economies, Taiwan's growth will slow from almost 7 percent last year to about 6 percent in 1990-91, while Korean growth will increase about one percentage point to around 8 percent this year and next. Contributing to this constant growth scenario will be a reduced rate of export expansion and smaller trade surpluses. With greater emphasis on domestic consumption by the traditionally fiscally conservative NIEs, the fiscal balances are projected to turn from surpluses in 1986-88 to deficits in 1990-91.

The aggregate current account deficit of the non-OPEC LDCs is projected to increase slightly to the $19-20 billion range in 1990-91, from an estimated $18 billion in 1989.

Current account developments in the NIEs will be dominated by Korea and Taiwan. Overall, the combined current account surplus of the NIEs as a group should show a very small decline in 1990-91 (to $18 billion, from last year's $19 billion). The small widening of Korea's large surplus, as exports increase more than imports, is expected to be more than offset by the narrowing of Taiwan's surplus. In Taiwan, the adjustment that was already underway in 1988 should continue this year, reducing the current account surplus further. This projection, however, depends importantly on greater import penetration.

This current account projection for the NIEs tends to obscure another underlying trend in the adjustment process. Both Korea and Taiwan are running growing surpluses on the invisibles account (services and transfers). Thus, while there was a $3 billion increase in the combined merchandise surplus of the NIEs between 1986 and 1988, the increase in the aggregate current account balance was $6 billion, reflecting a $3 billion increase in the invisibles surplus over the same period.

Key developments shaping the combined Latin American current account deficit in 1990 and 1991 are: surpluses in Brazil that are larger than last year's but smaller than in 1988; and lower deficits in Mexico. In aggregate, Latin America's current account deficit is forecast to widen slightly (to $10 billion) in 1990 and 1991. We do not anticipate any dramatic developments on the trade side. The Latin American region's combined trade surplus is expected to remain little changed, in the $30-32 billion range.

The OPEC countries should experience only a small increase in their current account surplus this year as import increases are expected almost to match a slower rise in gas and oil export revenues. In 1991, the increase in the current account surplus may be larger as imports fail to keep pace with growing oil and gas exports. The slower growth in imports could reflect an effort of some countries to rebuild reserves, drained during several years of large current account deficits, as well as the inability of the smaller surplus countries to increase imports greatly. In both 1990 and 1991 the expected increase in OPEC oil revenues should reflect increases in both oil prices and export volume in response to world economic growth. Oil price increases are unlikely to exceed 5 percent per annum, as those OPEC countries with excess capacity should be willing to increase output, seeing their long-term interest in "price stability".

As worldwide demand grows, increases in OPEC export volume will depend on non-OPEC supply, which is likely to drop, largely as a result of a decline in output in the Soviet Union and the United States.

PART IV: POLICY ISSUES

Economic policies in the industrial countries will continue to be formulated, in the broadest sense, to achieve several basic macroeconomic objectives: to promote solid and sustained economic growth; to resist inflation pressures where they arise; to ensure the continued growth of international trade and the smooth functioning of the international payments system; and, to support a reduction of international trade and current account imbalances.

Establishing priorities, and translating them into concrete policy actions, is the principal objective of the international policy coordination process that has been developed and strengthened in recent years. The broad objectives identified above reflect a solid international consensus, and represent the core of agreements at the annual Economic Summit and OECD Ministerial meetings, meetings of the Summit country Finance Ministers and Central Bank Governors, and meetings of the IMF's policy-making Interim Committee.

Obviously, these objectives are closely related. Yet none perhaps is more fundamental than achieving sustained, balanced and non-inflationary growth: to stimulate international trade and neutralize the threat of protectionism; to promote the continued integration of the developed and developing economies, and create new opportunities for the poorest countries; to provide tangible support for far-reaching market reform measures in the centrally planned economies; and, to ensure smooth reduction of the existing imbalances among the industrial countries themselves.

The broad-based expansion experienced by the industrial countries for much of the past decade thus represents a considerable achievement. Since 1985, budget deficits have generally been reduced, growth has increased in surplus countries, external imbalances have declined, and exchange rates have moved to better reflect competitive realities.

Yet clearly much more remains to be done, and this recognition lies at the heart of the policy coordination process. The major industrial countries are committed to remaining on a path of solid, non-inflationary growth to provide the impetus for further external adjustment, economic progress in the less developed countries, and the market-oriented transformation of the centrally planned economies.

Achieving these shared objectives necessitates shared responsibilities. For its part, the United States is committed to substantial further reductions in the federal budget deficit, maintaining open global markets and improving its ability to compete in those markets, and improving its internal saving/investment balance. The key surplus countries -- Japan and Germany -- must pursue policies to ensure solid and sustained growth of domestic demand and imports, the necessary counterpart of growth and medium-term external adjustment elsewhere in the world.

The catalogue of policies needed to achieve these objectives is a broad one and so, therefore, is the scope of the policy coordination process. Traditional macroeconomic policies, including exchange rate policy, remain at the core of the process. In addition, however, it is widely recognized that structural rigidities in the individual economies can reduce the effectiveness of these policies and impede growth and adjustment.

Examples of these rigidities include: tax systems whose structure tends to discourage risk-taking, saving, and investment; subsidies that prevent the efficient allocation of resources; excessive government interference and regulations, including in the financial and other service sectors; labor market practices and regulations that discourage labor mobility and job creation; inadequate competition as a result of historically close relations among financial and industrial institutions; and, social safety nets whose construction discourages job-seeking and competition.

As a result, the policy coordination process has been expanded to include multilateral examination of structural rigidities and necessary reforms. In addition, these efforts complement and are complemented by ongoing work in other fora. One of the principal objectives of the Uruguay Round of trade negotiations is to improve and expand the scope of GATT disciplines in order to reduce structural hindrances to international trade in goods and services. At U.S. urging, significant work on structural rigidities is being done within the Organization for Economic Cooperation and Development, and substantial progress has been made in identifying the costs and international implications of domestic structural problems. Finally, the United States and Japan are presently engaged in an intensive bilateral examination of structural factors that tend to impede external adjustment in both countries.

Of course, none of these efforts alone is adequate. Together, however, they represent a coordinated and evolving effort to develop effective international and domestic solutions to medium-term problems. In addition, the policy coordination process has the great advantage of informality and flexibility, with its scope and focus subject to change over time to reflect changing economic realities.

The need for appropriate and forward-looking policies does not end with the industrial countries. The Less Developed Countries (LDCs) also have crucial responsibilities, to promote their own advancement and to strengthen the international system upon which all depend.

For example, as major players in the international trading system, the NIEs have a particular responsibility to contribute effectively to the global adjustment process with market-oriented domestic and external policies, especially in the exchange rate, structural, and trade areas. These issues are being pursued both bilaterally and multilaterally. Progress is being made, although much more remains to be done.

The debtor countries need to pursue policies to strengthen domestic capital formation, reduce inflation and capital flight, and put fiscal and monetary policies on a sound footing. Excessive regulation and public sector intervention should be eliminated; prices, interest rates, and exchange rates need to be determined by market forces; investment policies should encourage a return of flight capital and greater engagement by foreign investors; and, trade policies should focus on improving domestic integration with the global economy.

The decade of the 1980s produced real progress in a number of areas: in the actual performance of the industrial economies; in our collective understanding of international economic linkages; in our success in developing effective, coordinated responses to complex international economic problems; and, in the growing, worldwide recognition that outward-looking, market-oriented policies offer the best prospects for prosperity. The challenge for the 1990s is to build on these achievements and make further progress on the substantial problems that still remain.

PART V: IMPACT OF TRADE BARRIERS*

The Congress requires the reporting of foreign barriers to U.S. trade in the National Trade Estimate Report on Foreign Trade Barriers, as revised by Section 1304 of the Omnibus Trade and Competitiveness Act of 1988. The law also requires quantification, where feasible, of the estimated effects of individual barriers to U.S. exports of goods and services and on U.S. foreign direct investment. This National Trade Estimate Report is due and will be sent to the Congress by March 31, 1990. Submission of the present Annual Trade Projection Report to Congress is required by March 1, 1990.

Because of the interval between the mandatory submission dates for the two reports, the National Trade Estimate Report is in preparation as the Annual Trade Projection Report goes to press. For a listing of foreign trade barriers and their impact on U.S. trade and investment, the Congress is, therefore, referred to the forthcoming National Trade Estimate Report.

There are, however, certain fundamental observations which can be made regarding the impact of foreign trade barriers on U.S. trade. Trade barriers can and do have substantial impact on exports, imports, production and trade balances for specific product areas and, to a lesser extent, for specific U.S. bilateral trade relations. However, trade barriers may have little impact on the aggregate imbalance in U.S. trade in the long run. Macroeconomic factors play the major role in determining trade balances.

Summing the estimated effects of individual trade barriers would overestimate the impact of the elimination of foreign trade barriers on the U.S. trade balance. The "partial equilibrium" framework in which trade barrier effects are usually estimated, in fact, precludes the drawing of any derivative implications of specific trade barriers for the aggregate trade balance.

Trade barriers have particular economic importance because they introduce microeconomic inefficiencies (resource misallocation) in production and impose real costs on the nation. They impair productivity and restrict the growth in real incomes. However, their effect on aggregate trade balances or the projection of aggregate trade balances is limited.

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* This section prepared by the Office of the United States Trade Representative